

Islamic Liquidity Management

Warren Edwardes, ceo, Delphi Risk Management Limited
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- *articles on Islamic banking on: dc3.co.uk/islamicbanking*
- *PowerPoint: dc3.co.uk/islamicliquidity031008.ppt*
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Thoughts on Liquidity

It may seem obvious, but it is not always taken into account that liquidity is about more than having a listing. Just because it is listed does not mean that someone is out there ready to buy it the moment you wish to sell it.

Liquidity is more than being negotiable with a secondary market. It is more than availability of proceeds on demand. Just because someone guarantees to buy back a bond from you does it make it liquid? What's the bid/offer price? Just sellers and no buyers?

I was in British Gas's Treasury during the Falklands war in 1982. British Gas was at the time a state owned industry and accordingly I was selling AAA Commercial Paper into the US market. There was an explicit UK government guarantee. But transatlantic allies or not appetite for British Gas paper completely dried up during the war and the CP was dumped and the bid/offer spread widened. Nobody wants to hold paper of an entity that is in the news.

I was in Midland Bank's Treasury during the crises in its subsidiary Crocker Bank in 1985. There was a massive dumping of Midland Bank's Certificates of Deposit and no buyers. Liquidity management was extremely difficult even within a conventional bank.

And Continental Illinois also fell as a result of liquidity failings. They had various and plentiful "liquid" instruments in their asset portfolio. However, when bad news came banks were not prepared to lend to them. As I said, nobody wants to hold paper of an entity that is in the news. And Continental Illinois did not have a

diversified pool of retail liabilities. Their liabilities were almost entirely concentrated in the wholesale market. And that market is at its most fickle when you need it. So liquidity is also about the diversification of liabilities.

Liquidity is therefore about having access to a determinate amount of cash and when you need it. This can be either through the asset side or the liability side of the bank or financial institution.

On the asset side, it is about the preservation of capital on demand. That means that the asset must have undoubted quality with minimal credit risk. And it must be seen to have that quality behind it. Remember what I said about British Gas's commercial paper. The UK Government was not about to default but that did not stop US investors dumping my paper.

That also means it must be free from price risk. I have come across so many instruments where the issuer or the broker guarantees to make a market in the paper and buy it back on demand. Such a guarantee is worthless I say. What's the point of a guaranteed repurchase if the price is not part of the guarantee?

Sukuks as we will soon be hearing about are a most welcome development but sound Asset/Liability Management still requires a top quality overnight instrument with stable capital.

Background to Islamic Liquidity

"Islamic banking in the Middle East is having a growth spurt. In the last five years, Islamic commercial banks have grown more rapidly than their conventional equivalents and the fledgling investment banking sector has begun to spread its wings with more confidence. At the same time, bankers complain that old obstacles remain - a lack of consensus between banks about what is or is not Islamic, a shortage of longer-dated assets and inter-bank liquidity, and the absence of an Islamic capital market. However, there are some signs that tentative moves are being made to address these shortcomings." Middle East Economic Digest - December 19, 1997

This was written nearly six years ago but there is still an Asset / Liability Gap Management problem for Islamic banks at the very short end in that there is a

dearth of instruments. The Liquidity Management Centre and the International Islamic Financial Market in Bahrain and others have done some excellent work and new Islamic liquid instruments such as the Sukuks issued by Malaysia, Bahrain and more recently by the IDB and are coming on stream on a regular basis. Malaysia of course has had such instruments in its domestic market for some time. There have been great strides made but much more work needs to be done.

Without an efficient capital market to operate within, Islamic banking finance will not continue to grow meaningfully. The market requires liquidity and price transparency to enhance a secondary market. It is all very well having entire issues oversubscribed – but there has to be an exit route to demonstrate liquidity. And this lack of truly liquid assets has led to an excessive demand for liquidity.

Liquidity management

Islamic banks investing in long-term assets are still faced with a problem in that most of their deposit liabilities are very short-term leading to a massive liquidity problem. Liquidity management tools that are both flexible and undeniably Shari'ah compliant are lacking. Although Sukuks can be traded most are held to maturity. There is a current discussion in an Islamic finance yahoo group about going short on Islamic assets. This lack of market liquidity is often seen as one of, if not the, major constraint to the development of an integrated Islamic financial system. Malaysia is an exception where they even have overdrafts.

Many Islamic banks place their surplus funds with Western banks through Murabaha trading on the London Metal Exchange. But these are largely bilateral trades and counterparty limits pose a problem. There are some funds but nothing that could handle a multi-billion dollar market.

It is inevitable that competition between various conventional banks and Islamic ones has led to segmentation and prevented a really substantial market developing leading to an upwardly spiralling virtuous vortex of liquidity. For things to change there will need to be more co-operation amongst Islamic banks and between them and their Conventional counterparties. The LMC and IIFM are

providing just such a lead and we should expect ground breaking developments in just months and not years.

Absence of inter-bank market poses problems

In addition to the lack of long-term assets to invest in and get out of, Islamic banks face another serious problem in balance sheet management: the lack of an Islamic inter-bank market. Because Islamic banks unlike Conventional banks cannot borrow at interest to meet unexpected withdrawals from their depositors, it is difficult for them to run mismatched asset and liability portfolios. And this is aside from the interest rate risk they run when they invest long at fixed rate and have their liabilities re-price frequently.

The way banks have most commonly solved this problem is to have more liquid assets than would be in the case of Conventional banks and these are placed with commodity murabahas on the understanding that they can get liquidity when required through early cancellations at an explicit or hidden cost.

There are a few Islamic liquidity vehicles but these are fairly small and could not withstand a several hundred dollar injection or withdrawal. There needs to be a market-wide central solution that allows institutions to park funds between medium to long term investments. We need a solution that involves high quality, standardisation, gets away from bilateral Murabaha investments by the investor with all the problems of break clauses, listing and price transparency and be able to transact in substantial size. Several initiatives are in hand there are likely to be some announcements by the end of the year.

Conclusion and Summary

Whilst there have been a number of Islamic Sukuks (Islamic Bonds) issued recently, most of the paper is bought to hold rather than trade. Thus liquidity is a problem both for on sale and price determination and mark to market is difficult. This is a result of a combination of two factors. There is a shortage of quality paper issued into the market and also the view in some quarters that the trading of debt is not Shari'ah compliant. A way to meet the Islamic restrictions on debt selling I believe would be to use Novation rather than selling. Thus there would be

a cancellation of the old agreement and establishment of a new agreement between the parties. The Novation could be included as part of the contract note.

In terms of Asset / Liability Management there is a hedging problem for institutions that lend long term at fixed yield through Ijaras and finance through short term and therefore variable yield accounts. There is thus a pressing need for Islamic derivatives to address this gap problem. But most derivatives are deemed to be Haram or not Shari'ah compliant on the grounds of being gambling. Perhaps "Financial Takaful (insurance)" would be a better banner to address this problem and a number of institutions believe they have much needed solutions to this problem.

There is also a problem in terms of the lack of Islamically compliant short-term liquidity instruments. The Sukuks even if they were traded and liquid are medium to long term. They are thus not price stable. And the current shortage of credit lines to some Middle Eastern institutions has led to an increase in short term cash holdings but the lack of suitable instruments creates a liquidity trap. There needs to be a truly global-sized liquid inter-bank market where institutions can park their liquidity reserves.

Warren Edwardes 8th October 2003.